Lemmen v. Commissioner, 77 T. C. 1326 (1981)

When an investment in cattle includes a maintenance contract, the purchase price must be allocated between the cattle's fair market value and the maintenance contract, with the latter amortized over its useful life.

Summary

Gerrit B. Lemmen purchased two cattle herds from Calderone-Curran Ranches, Inc. (CCR), at inflated prices, along with maintenance contracts. The issue was whether these were profit-motivated investments or tax shelters, and how to allocate the purchase price between the cattle and the maintenance contracts. The court found Lemmen's investments were for profit and ruled that the basis for depreciation of the cattle should be their fair market value, with the excess allocated to the maintenance contracts and amortized over their respective terms.

Facts

Gerrit B. Lemmen purchased a herd of cattle for $40,000 in 1973 and another for $20,000 in 1974 from CCR, with each herd having a fair market value of $7,000 at the time of purchase. The purchases included maintenance contracts for seven and three years, respectively, with options for renewal. The contracts allowed CCR to retain certain progeny as maintenance fees, and included repurchase obligations at the end of the contract periods. Lemmen, a high-income earner, sought investment credits and depreciation deductions for his investments.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Lemmen's federal income taxes for 1973-1975, disallowing his claimed investment credits and depreciation deductions, asserting that his cattle-breeding activity was not for profit. Lemmen petitioned the U. S. Tax Court, which found in his favor on the profit motive issue but limited his basis in the cattle to their fair market value and allocated the excess purchase price to the maintenance contracts for amortization.

Issue(s)

1. Whether Lemmen's investment in polled Hereford cattle during the years in question constituted an activity engaged in for profit?
2. Whether the excess of the purchase price of the cattle over their fair market value at the time of purchase represents an intangible asset that is not subject to amortization or depreciation?

Holding

1. Yes, because Lemmen's investments were motivated by a reasonable expectation of profit, supported by his due diligence and understanding of the investment's

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economics apart from tax benefits.
2. No, because the excess over fair market value was allocable to the maintenance contracts, which were subject to amortization over their useful life.

Court’s Reasoning

The court applied Section 183 of the Internal Revenue Code to assess Lemmen’s profit motive, considering factors such as his due diligence, the economic structure of the investment, and his intention to hold the cattle long-term. The court rejected the Commissioner’s argument that the investment was primarily for tax benefits, finding that Lemmen’s expectation of profit was reasonable. On the second issue, the court relied on the principle that when a package deal includes assets and services, the price must be allocated based on fair market values. The court determined that the inflated purchase price was partly payment for the maintenance contracts, which had a determinable useful life and thus were amortizable.

Practical Implications

This decision clarifies that when cattle are sold with maintenance contracts, the purchase price must be split between the cattle and the contracts for tax purposes. Investors in similar arrangements must carefully allocate their basis and consider the amortization of maintenance contracts over their term. The ruling impacts how tax professionals advise clients on cattle investments and emphasizes the need for thorough due diligence to establish a profit motive. Subsequent cases have applied this ruling when addressing bundled asset and service transactions in various investment contexts.

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